Part C. Property and Casualty Insurance Companies

This Part discusses proposals to curtail favorable tax rules for property and casualty (P&C) insurance companies. The deduction for estimated unpaid losses, which is currently allowed on an undiscounted basis, would be allowed only to the extent of the discounted present value of the losses. Special provisions that reduce the effective tax rate on P&C insurance companies would be eliminated. Thus, the deduction for contributions to a protection against loss account would be repealed. The deduction for policyholder dividends by mutual P&C companies would be repealed. The deduction for policyholder dividends by mutual P&C companies would be limited in conformity with the deduction allowed mutual life insurance companies.

LIMIT PROPERTY AND CASUALTY INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 12.10

Current Law

Property and casualty ("P&C") insurance companies are allowed a deduction for "losses incurred" during a taxable year. The deduction includes the company's estimate of "unpaid losses," whether or not unpaid losses have accrued under traditional tax accounting rules. Unpaid losses include amounts that will be paid in connection with claims filed with the company during the taxable year as well as amounts that relate to claims expected to arise from events occurring during the taxable year that have not been reported to the company. The deduction for these claims generally is not discounted to reflect the fact that they will not be paid until some time in the future.

Reasons for Change

The deduction of additions to reserves, unadjusted for the investment income that will be earned on those reserves, results in deferral of P&C companies' tax liability and reduces their effective tax rates. In other cases where tax deductions for additions to reserves are allowed, such as for life insurance companies, the allowable reserves are discounted for the expected future investment earnings on the reserve funds. The reserve deduction available to P&C companies should also be discounted.

The current tax treatment of P&C insurance reserves distorts the choice between self-insurance and third-party insurance. P&C companies deduct currently the full amount of the future liability for many casualty losses that would not be deductible currently by the self-insurer. Because a current tax deduction is more valuable than a future deduction, individuals and businesses are encouraged to insure against risks with a P&C company in order to take advantage of this favorable tax treatment.

Proposal

The deduction by P&C companies for unpaid losses during a taxable year would be computed under the "qualified reserve account" method. Under this method, the company would establish reserve accounts for claims to be paid in an amount estimated by the company to be sufficient to fund payment of the claims, taking into account the company's estimates of the amount of the claims, the time of payment of the claims, and the company's after-tax rate of return on its investment assets. Separate reserve accounts would be established by line of business and year of policy issuance. In other words, one account would be established for all claims under all policies in a particular line of business issued in a particular taxable year.

The initial reserve with respect to a policy could not exceed the premiums received under the policy reduced by the share of the company's deductible sales and administrative expenses allocated to the policy. Beyond this, the company would not be subject to federally prescribed rules for discounting future losses in establishing the reserve account. Instead, the company would be free to use any reasonable discounting method (e.g., the same estimates it used in pricing its insurance policies).

Each reserve established by the company would be increased annually by a percentage equal to the after-tax rate of return actually earned by the company on its investments during that year. To prevent the company's investment income from being sheltered from tax, no additional reserve deduction would be allowed for the annual increase in the reserve accounts attributable to the allocation of investment income.

The company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an offsetting amount released from the appropriate reserve account. This would ensure that, if the company's estimates of the amount and timing of claims and after-tax rate of return on investment assets were accurate, the reserve would be exhausted and the last claim would be paid simultaneously. If the reserve was insufficient to cover all claims, the excess claims would be deductible when paid. Conversely, if any amount remained in a reserve account after payment of the last claim in that account, that amount would be included in taxable income.

A company would be permitted to strengthen a reserve it felt was insufficient to cover future claims and a deduction would be given for additional amounts placed into a reserve. However, the company would be required to establish the need for reserve strengthening by a showing of objective factors affecting the amount needed to fund the payment of claims. Such factors would include a strengthening of the company's reserves on its annual statement or a decline in prevailing interest rates. Companies also would be free to release into income additional amounts from reserves it felt to be excessive. This would allow companies to avoid or reduce a large income item in a single year from the release of an excessive reserve.

A company would not be able to maintain a reserve indefinitely. Rules would be established limiting the maximum life of a reserve, depending on the line of business. Any reserve balance at the end of the maximum life would be released into income. Any subsequent claims under policies covered by that reserve would be deductible when paid.

Effective Date

The proposal would be effective for all unpaid losses with respect to all policies issued on or after January 1, 1986.

Analysis

Under the proposal, P&C companies would still be permitted to use the reserve method to match income and losses occurring in different taxable years. The discounting of losses, however, would prevent the reserve deduction from yielding greater tax benefits than a deduction claimed at the time the losses are paid or accrued. Discounting the amount of allowable reserves for tax purposes would take into account the time value of money. A current deduction of $1,000 is worth considerably more than a future deduction of $1,000 because investment income will be earned on the tax saving. For the same reasons, less than $1,000 needs to be held in reserve to fund a future liability of $1,000. For example, if interest income accumulates at an after-tax rate of six percent, a reserve of only $792.09 is needed to provide sufficient funds to satisfy a liability four years in the future of $1,000.

A substantial portion of the claims paid by P&C companies are paid in years subsequent to the year in which premium income is received and a deduction for losses paid or incurred is claimed. Table 1 shows the average period of loss payment for all insurance written by P&C companies and for several major lines of business. As shown on the table, over 60 percent of all losses of P&C companies are paid after the year of deduction. The actual discounted value of these losses at the time the premium income is received, assuming a six percent discount rate, is approximately 91 percent of their undiscounted value. In the case of medical malpractice insurance, a line of business where long delays in the payment of claims are common, more than one-half of all losses are paid beyond the fourth year after the year of deduction and the discounted value of the losses at the time the premium is received is only approximately 76 percent of their undiscounted value.

It has been argued by some that the present system of undiscounted claims reserves results in "rough justice" since it allows a deduction to some taxpayer in the full amount of an economic loss (of either the policyholder or a third party to whom the policyholder is liable) when the loss is incurred. Arguably, it is proper to match the time of the P&C company's deduction to the time the underlying economic loss is sustained. However, except in the case of business losses, a large portion of property and casualty liabilities would not be deductible losses to the party suffering the underlying economic loss. For instance, individual taxpayers can claim a casualty loss deduction on personal property only for the amount of loss in excess of ten percent of the individual's adjusted gross income. Deductions for medical expenses are limited to those in excess of five percent of adjusted gross income. In the case of medical malpractice and workers'

Table 1

Timing of Loss Payments to Total Losses Incurred
by Major Lines of Business of Property and Casualty
Insurance Companies - 1975 to 1983 Experience

Time Between Loss Incurred and Payment	Payments as Percent of Losses Incurred					
	Line of Business					
	All Business	Auto Liability	Other Liability	Medical Malpractice	Workers' Compensation	Multiple Peril
Same year	36.7%	36.0%	12.1%	5.8%	27.4%	56.2%
1 year	26.1	29.7	15.6	8.6	24.8	26.2
2 years	10.5	14.4	11.4	9.0	12.7	5.1
3 years	8.3	9.0	13.1	12.1	8.8	4.5
4 years	4.6	4.5	9.9	10.3	4.9	2.3
5 years	3.2	2.6	8.3	10.6	3.6	1.4
6 years	2.4	1.2	7.0	8.1	2.9	1.3
7 years	1.4	0.9	6.5	3.3	1.4	0.7
8 years or later	6.7	1.8	16.2	32.1	13.7	1.6
Present value loss of $100 incurred. 1/	$90.56	$92.40	$81.34	$76.28	$87.48	$95.13

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1/ Discounted by the payment stream at six percent. Assumes payments are made in the middle of the year and discounted to the middle of the first year. The present value is overstated because many of the payments eight years or later are not fully discounted, which would particularly affect medical malpractice, other liabilities, and workers' compensation.

compensation liabilities, payments on contested or uncertain liabilities generally are not deductible by the policyholder until payment is actually made nor is the "economic" loss to the injured party generally a deductible expense to such party.

It has also been argued that it is inappropriate to mandate the discounting of reserves for Federal tax purposes because P&C companies are generally underreserved (as a result of underestimating future claims). Under current law, however, even a company that has established an initial reserve equal to (or even less than) the present value of a future claim derives a significant benefit. For example, if a P&C company establishes a reserve of $792.09 for a future claim that it estimates will be $792.09, and if the claim turns out to be $1,000, the company will receive an additional deduction of $207.91 when the claim is paid, even though it received a full deduction (in present value terms) when the reserve was established.

The discounting of reserves for tax purposes would not affect State law requirements for reserves to protect policyholders against company insolvency. State law would continue to require adequate funding of statutory reserves. The tax reserve account would be smaller than the statutory reserve and would be only a bookkeeping entry. The lower tax reserve would increase the current tax liability of P&C companies and affiliated companies, but as described above the proposal would simply eliminate the deferral of tax liability allowed under current law. P&C companies could be expected to increase their premiums to cover any increased tax liability resulting from the more accurate measurement of their taxable income.

The property and casualty industry may argue that this proposal is not appropriate for an industry with large underwriting losses (-$11.0 billion in 1983). However, as shown in Table 2, P&C companies earned total net income of $6.6 billion in 1983, this being the excess of their $17.9 billion of investment income over their underwriting losses. The large underwriting losses occur because P&C companies lower premiums (discount) for the expected future investment income, but they currently do not discount statutory reserves which are used in calculating underwriting income. Total net income is the appropriate measure of company profitability, not underwriting income.

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Table 2

Investment Gain and Underwriting Loss of Property
and Casualty Insurance Companies - 1979 to 1983
(In millions of dollars)

Year	Net Underwriting Gain or Loss	Net Investment Gain or Loss	Other Miscellaneous Income	Total Net Income 1/
1979	$ - 21	$ 9,607	$ - 161	$ 9,424
1980	-1,819	11,628	- 208	9,601
1981	-4,563	13,520	- 265	8,692
1982	-8,302	15,479	- 406	6,771
1983	-11,033	17,923	- 306	6,584

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1/ Before policyholder dividends.

Source: Best's Aggregates and Averages.

The principal advantage of the qualified reserve account method of discounting reserves is that it assures that the ultimate after-tax return that a company realizes on a group of policies does not depend on the amount the company places into the reserve for those policies, assuming that the company's tax rate is constant over time. In fact, the qualified reserve account method would yield the same ultimate after-tax return as the cash method of accounting, although it would achieve a better matching of income and deductions on a year-by-year basis. This means that it would be unnecessary to prescribe a Federal standard for discounting reserves -- companies are free to discount using any reasonable set of assumptions (e.g., the assumptions used in pricing the policies). A company would not have a tax incentive to overreserve since any excess tax deduction would be recaptured when the claims are ultimately paid with an interest factor equal to the company's actual after-tax rate of return. Conversely, companies that underreserve would receive additional deductions at the time they pay their claims to ensure that they will not be penalized for underreserving.

REPEAL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY PROTECTION AGAINST LOSS ACCOUNT

General Explanation

Chapter 12.11

Current Law

Most mutual property and casualty (P&C) insurance companies are allowed deductions for net contributions to a protection against loss (PAL) account. A deduction is generally allowed for contributions to the account in an amount equal to one percent of the losses (both known and estimated) incurred during the taxable year plus 25 percent of the underwriting gain for the taxable year. Companies that have a high percentage of risks relating to windstorms, hail, flood, earthquakes, or similar hazards may defer a larger percentage of their underwriting income.

The portion of the deferred income representing one percent of losses incurred and one-half of the deduction for 25 percent of underwriting income is brought back into income after, at most, a five-year deferral period. The remaining amount, 12.5 percent of underwriting income, continues to be deferred indefinitely, until the company has underwriting losses.

Reasons for Change

The special PAL deduction is unrelated to the measurement of economic income. The PAL deduction is allowed in addition to the full deduction that mutual P&C companies receive for estimates of future losses. Furthermore, the PAL account is simply a bookkeeping entry made for tax purposes; a corresponding reserve account is not required by State regulatory authorities to provide for the financial solvency of the companies.

The tax deferral resulting from the deductibility of contributions to a PAL account reduces the effective tax rate on mutual P&C companies with underwriting income. The lower effective tax rate provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and life insurance companies that offer similar insurance products.

The calculation of the PAL account requires an arbitrary distinction between underwriting and investment income. This distinction increases the complexity of the tax code and increases the possibility that companies will undertake uneconomic transactions solely to minimize tax liability.

Proposal

The deduction for contributions to a PAL account would be repealed. Amounts currently held in the account would be included in income no later than ratably over a five-year period.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The benefits of the special PAL deduction accrue largely to profitable companies that do not have underwriting losses and therefore obtain the maximum tax deferral. The special deduction provides little benefit to companies with periodic underwriting losses. Repeal of the special PAL deduction should have minimal impact on premium rates.

REPEAL SPECIAL TAX EXEMPTIONS, RATE REDUCTIONS, AND DEDUCTIONS OF SMALL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANIES

General Explanation

Chapter 12.12

Current Law

Numerous special rules reduce or eliminate the tax liability of certain small mutual property and casualty (P&C) insurance companies. Mutual P&C companies with taxable investment and underwriting income of not more than $6,000 are exempt from tax; a limitation on the rate of tax on income in excess of $6,000 phases out between $6,000 and $12,000. Mutual P&C companies that during the taxable year receive a gross amount of not more than $150,000 from premiums and certain investment income are also exempt from tax, regardless of the amount of their taxable income. Unless they elect to the contrary, companies that receive a gross amount from premiums and certain investment income of more than $150,000 but not more than $500,000 are taxed only on their investment income (and are not taxed at all if their investment income is not more than $3,000); their underwriting income is exempt from tax. A limitation on the rate of tax on the investment income of such companies in excess of $3,000 phases out between $3,000 and $6,000. A further reduction of the rate of tax on the investment income of such companies phases out as the gross amount from premiums and certain investment income increases from $150,000 to $250,000. Finally, mutual P&C companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Reasons for Change

The special tax rules that reduce or eliminate the tax liability of certain small mutual P&C companies provide competitive advantages to those companies vis-a-vis stock companies and larger mutual companies. The application of these rules requires arbitrary distinctions between underwriting and investment income, thereby increasing the complexity of the tax code.

Proposal

The special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed.

Effective Date

The proposal would be phased in over a five-year period, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Small mutual P&C companies would be placed on a par with all other P&C companies and other small corporations. Elimination of preferential rates based on the size of the firm would end tax-induced distortions that favor the sale of insurance through small firms.

LIMIT MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY DEDUCTION FOR POLICYHOLDER DIVIDENDS

General Explanation

Chapter 12.13

Current Law

In general, stock and mutual property and casualty (P&C) insurance companies are allowed to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. These distributions are treated by policyholders as price rebates rather than as taxable distributions. Because policyholder dividends distributed by mutual companies are substantially larger than similar distributions by stock companies, this deduction primarily benefits mutual P&C companies.

In the case of life insurance companies, the amount of the deduction allowed mutual companies for policyholder dividends is subject to certain limitations. The deductibility constraint stems from a recognition that policyholder dividends paid by mutual companies are, to some extent, distributions of the companies' earnings to policyholders in their capacity as owners of the company. Consequently, the deduction for policyholder dividends is reduced by an amount determined to be the owner/policyholder's share of the distributed earnings of the company.

Reasons for Change

The allowance of a deduction for income distributed in the form of policyholder dividends by mutual P&C companies provides a competitive advantage to such companies vis-a-vis stock P&C companies and other corporations. This competitive advantage of mutual companies was recognized in the 1984 overhaul of the life insurance company tax rules, which imposed a limitation on the deductibility of policyholder dividends by mutual life insurance companies. A similar limitation on the deductibility of mutual P&C company policyholder dividends would ensure that corporate profits are taxed at least once, thereby reducing the distortion caused by the deduction.

Proposal

The deduction for policyholder dividends allowed mutual P&C companies would be reduced in a manner similar to the way in which the deduction for policyholder dividends allowed mutual life insurance companies is reduced under current law.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would subject all income of mutual P&C companies, including profits distributed to policyholders, to tax at the company level. Mutual companies may distribute a lesser amount of policyholder dividends and charge slightly higher premiums as a result of the tax on equity income, similar to the effect of corporate taxes on other companies. The advantage of mutual companies over stock companies would be reduced, as would the advantage of mutual P&C companies selling insurance products in competition with life insurance companies.